



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9573]

RIN: 1545-BF81

Damages Received on Account of Personal Physical Injuries or Physical Sickness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion from gross income for amounts received on account of personal physical injuries or physical sickness. The final regulations reflect amendments under the Small Business Job Protection Act of 1996. The final regulations affect taxpayers receiving damages on account of personal physical injuries or physical sickness and taxpayers paying these damages.

DATES: Effective Date: These regulations are effective on **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For date of applicability, see § 1.104-1(c)(3).

FOR FURTHER INFORMATION CONTACT: Sheldon Iskow, (202) 622-4920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that amend the Income Tax

Regulations (26 CFR part 1) to reflect amendments made to section 104(a)(2) of the Internal Revenue Code (Code) by section 1605(a) and (b) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1838 (the 1996 Act). On September 15, 2009, a notice of proposed rulemaking (REG-127270-06) was published in the **Federal Register** (74 FR 47152). Written comments responding to the notice of proposed rulemaking were received. The comments are available for public inspection at www.regulations.gov or on request. A public hearing was requested and held on February 23, 2010. After consideration of all the comments, the proposed regulations are adopted without substantive change by this Treasury decision. The comments are discussed in the preamble.

Summary of Comments

The proposed regulations deleted the requirement that to qualify for exclusion from gross income, damages received from a legal suit, action, or settlement agreement must be based upon “tort or tort type rights.” The proposed regulations provided, instead, that the section 104(a)(2) exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute that does not provide for a broad range of remedies, and that the injury need not be defined as a tort.

A commentator suggested that eliminating the tort type rights test would create confusion about what constitutes a personal injury. The commentator suggested that the regulations should retain the tort type rights test but clarify that meeting the test does not depend on the nature of the remedies or the state

law characterization of the cause of action.

The final regulations do not adopt this comment. Before the 1996 amendment, the section 104(a)(2) exclusion was not limited to damages for physical injuries or sickness. The tort-type rights test was intended to distinguish damages for personal injuries from, for example, damages for breach of contract. Since that time, however, Commissioner v. Schleier, 515 U.S. 323 (1995), has interpreted the statutory “on account of” test to exclude only damages directly linked to “personal” injuries or sickness. Furthermore, under the 1996 Act, only damages for personal physical injuries or physical sickness are excludable. These legislative and judicial developments have eliminated the need to base the section 104(a)(2) exclusion on tort cause of action and remedy concepts.

A commentator requested that the final regulations address whether a claimant has constructive receipt or the current economic benefit of a damage award that is set aside for the claimant’s benefit in a trust or fund, such as a qualified settlement fund described in §1.468B-1. Other commentators asked that the final regulations define certain personal injuries as physical injuries and describe the circumstances in which emotional distress is attributable to physical injuries.

The final regulations do not adopt these comments because they are beyond the scope of the proposed regulations, which did not propose rules on the issues raised by the comments. However, these comments will be considered if guidance is published on these topics in the future.

Effective/Applicability Date

These regulations apply to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. This September 13, 1995, effective date derives from an exception set forth in section 1605(d)(2) of the 1996 Act to the statutory effective date of the amendments to section 104(a)(2).

In addition, taxpayers may apply these regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996, and if otherwise eligible may file a claim for refund for a taxable year for which the period of limitation on credit or refund under section 6511 has not expired. To qualify for a refund of tax on damages paid after August 20, 1996, under a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, a taxpayer must meet the requirements of the 1996 Act, including the requirement that excludable damages must be received on account of personal physical injuries.

Special Analyses

This Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Sheldon Iskow of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.104-1, paragraph (c) is revised to read as follows:

§1.104-1 Compensation for injuries or sickness.

* * * * *

(c) Damages received on account of personal physical injuries or physical sickness--(1) In general. Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit

or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. For purposes of this paragraph (c), the term damages means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(2) Cause of action and remedies. The section 104(a)(2) exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law.

(3) Effective/applicability date. This paragraph (c) applies to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Taxpayers also may apply these final regulations to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996. If applying these final regulations to damages received after August 20, 1996, results in an overpayment of tax, the taxpayer may file a claim for refund

before the period of limitations under section 6511 expires. To qualify for a refund of tax on damages paid after August 20, 1996, under a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, a taxpayer must meet the requirements of section 1605 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1838).

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Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: December 6, 2011.

Emily S. McMahon,
Assistant Secretary of the Treasury (Tax Policy).

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